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608504—44

In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 362

THE HIRSCH IMPROVEMENT COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the United States Board of Tax Appeals (now the Tax Court of the United States) (R. 180–200), entered October 6, 1942, are unreported. The opinion of the United States Circuit Court of Appeals for the Second Circuit (R. 255–261) is not yet reported.

JURISDICTION

The judgment of the circuit court of appeals was entered June 5, 1944. (R. 262.) The petition for a writ of certiorari was filed August 18,

1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Pursuant to the terms of a twenty-year sublease of a store building in Cleveland, Ohio, entered into by the petitioner with McCrory Stores Corporation, the lessee paid the petitioner $35,000, in the tax year 1936, to be applied by petitioner on account of rent and other payments to be made by the lessee for the last year of the term, unless it was otherwise applied upon a sooner termination of the lease as therein provided.

The question is whether the court below erred in affirming the decision of the Tax Court sustaining the Commissioner's inclusion of this amount in the petitioner's gross income for that year under Section 22 (a) of the Revenue Act of 1936.

2. Whether the petitioner was doing business in the tax year 1936 so as to subject it to the excess profits tax imposed by Section 106 (a) of the Revenue Act of 1935.

STATUTES INVOLVED

Revenue Act of 1935, c. 829, 49 Stat. 1014:

> SEC. 105 [as amended by Sec. 401 (a) of the Revenue Act of 1936, c. 690, 49 Stat. 1648]. CAPITAL STOCK TAX.[1]

[1] The 1936 amendment merely reduced the capital stock tax from $1.40 for each thousand of the adjusted declared value of the corporation's capital stock to $1 per thousand.

(a) For each year ending June 30, beginning with the year ending June 30, 1936, there is hereby imposed upon every domestic corporation with respect to carrying on or doing business for any part of such year an excise tax of $1 for each $1,000 of the adjusted declared value of its capital stock.

* * * * *

SEC. 106. EXCESS-PROFITS TAX.

(a) There is hereby imposed upon the net income of every corporation for each income-tax taxable year ending after the close of the first year in respect of which it is taxable under section 105, an excess-profits tax equal to the sum of the following:

6 per centum of such portion of its net income for such income-tax taxable year as is in excess of 10 per centum and not in excess of 15 per centum of the adjusted declared value;

12 per centum of such portion of its net income for such income-tax taxable year as is in excess of 15 per centum of the adjusted declared value.

* * * * *

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from pro-

> fessions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

STATEMENT

The petitioner was organized in 1922 for the purpose of taking over a 99-year lease on the Argyle Block in Cleveland, Ohio (R. 182–183). On March 24, 1924, the petitioner subleased the premises to McCrory Stores Corporation for a period of 90 years at an annual rental of $67,500 (R. 183).

On January 14, 1933, McCrory Stores Corporation filed a petition in bankruptcy, its sublease of the premises being thereafter disaffirmed by the trustee (R. 184). Later the petitioner settled its claim in bankruptcy against the McCrory Stores Corporation and entered into a new sublease with it for the period from June 1, 1936, to December 31, 1955. The rental agreed upon was $30,000 per annum for the first seven years of the lease and $32,500 per annum thereafter. The lessee agreed to anticipate the rental to the extent of $2,500 per annum for the first ten years by the payment of an additional sum of $25,000 upon the execution of the lease. (R. 185–186.) The lease

then provided for the payment of the $35,000, here in question, as follows (R. 186–187; see also the lease, R. 146):

> The lessee has, on delivery hereof, paid to the lessor the sum of thirty-five thousand dollars ($35,000), the receipt of which is hereby acknowledged, as security for the payment of rent and the performance of the covenants and conditions of this lease on the part of the lessee to be performed. It is understood and agreed that the lessor shall apply said sum on account of the rent and other payments herein provided to be made for the year ending December 31, 1955, except that in the event of default in the payment of rent or in the performance of the material and important covenants contained in this lease on the lessee's part to be performed, and the termination of this lease pursuant to the terms hereof prior to January 1, 1955, in which event the said security shall be retained by the lessor in payment of or on account of such damages as the lessor may sustain by reason of the termination of the lease because of the default on the part of the lessee. In the event such damages shall be less than the amount paid as such security the surplus, if any, shall be paid to the lessee. by the lessor.

The petitioner determined that neither the $25,000 above referred to nor the $35,000 here involved represented income, and that, therefore, these sums could not be distributed as dividends.

Nevertheless, the petitioner distributed $55,000 (of the total of $60,000) to its stockholders as "advances," and the amounts thus distributed were carried on the balance sheet as assets. The so-called advances were made without any intention or agreement that they should be repaid. No notes were given; the principal was not repaid, and no interest thereon has ever been paid. (R. 188–189.) Before the Tax Court, the petitioner claimed a dividends-paid credit for this $55,000 distribution (R. 197–199), and the Commissioner sought no review of the Tax Court's ruling in petitioner's favor (R. 258).

Since its incorporation, the petitioner's income has been derived from its leasehold. From 1924 to 1933, McCrory Stores Corporation was the sole tenant of the leasehold. Since 1933 that company has occupied only a portion of the premises, and the remainder has been sublet by the petitioner (since July 1, 1935 (R. 39)) to Robin Redbreast Hosiery Company, Inc., at a rental of a certain percentage of the latter's gross sales, which required the monthly submission of statements by the tenant to the petitioner. The last mentioned lease is for a period ending June 30, 1945. In the tax year, 1936, the petitioner, under an arrangement effective September 1, 1936, employed a bank in Cleveland as its agent in the collection of rentals and for the payment of the ground rent and taxes due from it. Any balance of income re-

maining was to be distributed by the agent on the petitioner's written instructions. (R. 189–190.)

During the period July 1, 1935, to June 30, 1936,[2] considerable time and effort were required on the part of the petitioner in securing the settlement with the McCrory Stores Corporation of the petitioner's claim against it in bankruptcy. The petitioner's board of directors held three special meetings between July 1, 1935, and June 30, 1936. These were the only formal directors' meetings that were held. No formal meeting of the stockholders was held during that period. The Robin Redbreast Hosiery Company, Inc., covenanted in its lease to keep and maintain the premises demised to it, including plumbing and electrical fixtures, elevators, etc., in good condition and repair. The petitioner covenanted to make all necessary repairs to the roof and sidewalk adjoining the premises. McCrory Stores Corporation covenanted in its lease to keep the interior of the premises demised to it in good repair, including the store fronts, show windows, and entrance way; and the petitioner covenanted to keep the exterior of the premises, including the sidewalk, in good repair, and to carry insurance against fire and lightning. Similar covenants covering repairs were contained in the earlier

[2] This is the period with which Secs. 105 and 106 (a) of the Revenue Act of 1935, as amended, are concerned (*supra*, pp. 2–3).

lease to McCrory Stores Corporation. (R. 190–191.)

The Commissioner included the $35,000 above mentioned in the petitioner's gross income for the tax year 1936 as prepaid rental (R. 24, 25), and, as a result of this and other adjustments, determined deficiencies in income and excess profits taxes of $17,014.24 (R. 27) and $7,310.72 (R. 26), respectively.

The Tax Court found and held that the $35,000 was paid to the petitioner as rent (R. 195–198). The Tax Court also rejected the petitioner's contention that it was not doing business from July 1, 1935, to June 30, 1936, and held that it was therefore not to be relieved from the excess profits tax it had paid in accordance with the return it had filed (R. 199–200). However, in view of other adjustments made by it, the Tax Court redetermined the deficiencies in the petitioner's income and excess profits taxes for the periods involved to be $8,230.33 and $5,939.95, respectively (R. 201).

The circuit court of appeals affirmed the decision of the Tax Court (R. 255).

ARGUMENT

1. The question as to the taxability of the $35,000 which the petitioner received from its lessee, the McCrory Stores Corporation, at the time of the execution of the new sublease of the premises for the period from June 1, 1936, to

December 31, 1955, depends for its solution upon the peculiar facts in the case, particularly on the terms of the lease itself. The court below so viewed the problem (R. 260); for, as it stated, the sum was to be repaid, in whole or in part, under circumstances which might never occur and of a kind so limited as to be an insufficient basis for requiring that sum to be categorized as primarily not intended as rent (R. 261). It correctly held that the lease here supports the Tax Court's decision (R. 261). Cf. *Brown* v. *Helvering,* 291 U. S. 193, 199.

The decision of the court below is not, as the petitioner asserts (Pet. 13–14; Br. 18–19), in conflict with the decision of the Circuit Court of Appeals for the Fifth Circuit in *Clinton Hotel Realty Corp.* v. *Commissioner,* 128 F. 2d 968. As the court below pointed out (R. 261), in so far as any expressions in the *Clinton Realty* case appear to be inconsistent with its decision in the instant case, such expressions "were qualified by a subsequent case in the same Circuit, *Astor Holding Co.* v. *Commissioner,* 135 F. (2d) 47 (C. C. A. 5) where the Court decided against the taxpayer on facts very similar to those of the instant case."[3] The decision of the Circuit Court of

[3] That the facts in the *Astor Holding Company* case are substantially similar to those of the case at bar is disclosed by the memorandum opinion of the Board of Tax Appeals of July 30, 1942 (1942 P–H B. T. A. Memorandum Decisions, par. 42,435), where the applicable provisions of the lease there in question are set out in full.

Appeals for the Fifth Circuit in the *Astor* case, which approved the inclusion of the amount there involved in the lessor's gross income, is in complete accord with the decision of the court below in the case at bar. In its opinion in the *Astor* case, the circuit court of appeals differentiated that case from the *Clinton Realty* case, where the amount paid was held not to be includible in the lessor's gross income. In so doing, the court pointed out that the amount paid in the *Clinton Realty* case was actually only a deposit or security for rent, because it was always referred to as "security" or "deposit" and because the lessor was required to account to the lessee for the principal thereof and the interest thereon. There were no such requirements in the lease involved in the *Astor* case, nor are there such requirements involved in the lease in the case at bar.

Warren Service Corp. v. *Commissioner,* 110 F. 2d 723 (C. C. A. 2d), which the petitioner inferentially asserts is also in conflict with the decision of the court below (Pet. 13), is a decision of that court and was said by it to be substantially different from the instant case (R. 261). The distinction is apparent, since in the *Warren Service Corporation* case the lessor was required to hold the $125,000 which the lessee had there paid it upon the execution of the lease in 1926 and to repay it to the lessee in full in 1941, unless it had in the meantime been appropriated by the

lessor to make good a default by the lessee. In other words, the amount was paid to the lessor only as a deposit to guarantee the performance of the lease by the lessee. The real question in that case was whether and how much income there was in 1933 when the lease and the obligation to repay the $125,000 was cancelled.

The decision of the Circuit Court of Appeals for the Ninth Circuit in the case of *Commissioner* v. *Lyon,* 97 F. 2d 70, also referred to by taxpayer (Pet. 14), is in accord with the decision of the court below in the instant case, for in the *Lyon* case the court held that a sum of money paid under the terms of a lease upon execution thereof, entirely without restriction concerning its disposition, was taxable in the year of its receipt.

2. Nor is there any basis for the petitioner's assertion (Pet. 14) that the determination of the court below on the "doing business" question is "in conflict with the weight of authority and applicable decisions of this Court", the decisions referred to being listed on pages 26–27 of its brief supporting its petition.

Both the Tax Court (R. 199–200) and the court below (R. 261) correctly held that the petitioner was doing business in the taxable year. The Tax Court found the facts in some detail (R. 189–191), and, in its opinion, stated that the petitioner "was organized to acquire a long-term leasehold and to make profit from subleasing the premises" (R.

199). It concluded, therefore (R. 200), that the petitioner's activities during the tax year brought it well within the rule as to what constitutes doing business laid down by this Court in *Edwards* v. *Chile Copper Co.*, 270 U. S. 452, and *Magruder* v. *Washington, B. & A. Realty Corp.*, 316 U. S. 69, and distinguished *McCoach* v. *Minehill Railway Co.*, 228 U. S. 295, upon which the petitioner relies, on the ground that the taxpayer there had, for all practical purposes, discontinued its business.

CONCLUSION

We believe the questions here presented are not of sufficient general importance to warrant review of the decision of the court below with respect thereto; and, since there is no conflict upon either question, and the decision below is correct, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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SEPTEMBER 1944.

U. S. GOVERNMENT PRINTING OFFICE: 1944